EXHIBIT 55

Governmental Accounting, Auditing, and Financial Reporting

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Funds, Fund Types, and Interfund Activity

Of all of the traits that distinguish accounting and financial reporting for state and local governments from accounting and financial reporting for businesses, perhaps the most obvious is fund accounting. This chapter will examine the crucial role that funds play in the public sector. It also will consider the appropriate accounting and financial reporting for activity between funds.

Nature and purpose of fund accounting

In the private sector, managers typically enjoy considerable discretion in how they apply financial resources to achieve an entity's objectives. They ultimately are accountable to their governing body (board of directors), of course, but mainly *after the fact*. Public-sector managers, in contrast, find themselves in a quite different position.

First, state and local governments often receive financial assistance from higher levels of government. In most cases, those resources must be used for purposes specified by the provider. That is, management's discretion on how to use the resources is *preempted*, to a large degree, by the resource provider. Management, for instance, could not redirect grant proceeds destined for low-income housing to finance infrastructure maintenance, even if management believed the money would be better spent on infrastructure than on housing.

Second, the legislative branch (governing body) exercises the "power of the purse" over the executive branch (management). Management needs the authorization of the governing body to raise and spend public money. This authorization normally takes the form of an annual (or biennial) appropriated budget, which legally limits the types of revenues that may be raised and how budgeted resources may be spent. Once again, management's discretion is *preempted* to a large extent, this time by the governing body. If resources were budgeted for equipment, for instance, a government's management normally would not legally be able to spend them instead on salaries. Likewise, resources budgeted for one department (police) often could not legally be spent for another (parks and recreation). Thus, there are significant constraints on how managers spend even a government's own-source revenues.

The first principal of accounting and financial reporting for state and local governments (Accounting and Reporting Capabilities) states that:

> A governmental accounting system must make it possible both: (a) to present fairly and with full disclosure the funds and activities of the governmental unit in conformity with generally accepted accounting principles, and (b) to determine and demonstrate compliance with finance-related legal and contractual provisions.[1]

Given the special compliance challenges of the public sector described earlier, state and local governments need some reliable yet practical means of determining and demonstrating "compliance with finance-related legal and contractual provisions." For almost a century, fund accounting has met that need. Thus, the second principle of governmental accounting and financial reporting for state and local governments (Fund Accounting Systems) states that "governmental accounting systems should be organized and operated on a fund basis." That principle goes on to define a *fund* as:

> a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.[2]

For example, a government might establish a separate *fund* to account for revenues from gasoline taxes that can only be spent on road repair and construction so as to ensure and demonstrate compliance with that requirement. Such a fund also might assist financial statement users with a particular interest in resources available for road repair and construction.

At the inception of fund accounting, individual funds most often corresponded to separate bank accounts. Since that time, advances in treasury management have reduced or eliminated the need for multiple bank accounts. Accordingly, today's funds may exist only as data sets within the government's information system.

Number of Funds principle

The third principle of governmental accounting and financial reporting for state and local governments (Number of Funds) states that:

> Governmental units should establish and maintain those funds required by law and sound financial administration. Only the minimum number of funds consistent with legal and operating requirements should be established, however, since unnecessary funds result in inflexibility, undue complexity, and inefficient financial administration.[3]

As explained previously,[4] it is important to distinguish *accounting* (collection and maintenance of detailed financial data) from *financial reporting* (aggregation of detailed data from the accounting system into a form suitable for decision making).

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1. National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, Principle 1. This definition was written essentially from the perspective of governmental funds. Proprietary funds and trust funds report capital assets as well, even though capital assets are not mentioned in this definition.
2. NCGA Statement 1, Principle 2.
3. NCGA Statement 1, Principle 3.
4. See Chapter 1.

EXHIBIT 4-1 Fund categories

Governmental funds	Used to account for activities primarily supported by *taxes, grants, and similar revenue sources*
Proprietary funds	Used to account for activities that receive significant support from *fees and charges*
Fiduciary funds	Used to account for resources that a government holds as a trustee or agent on behalf of an outside party that *cannot be used to support the government's own programs*

The number of funds necessary for *accounting* purposes (high level of detail) may be greater than the number of funds needed for *financial reporting* purposes (lower level of detail). Accordingly, the practical application of the Number of Funds principle often involves treating two or more of the funds used for accounting purposes as a single fund for financial reporting purposes.[5]

Fund categories

Financial activities for state and local governments fall into three broad categories. Some activities are financed through taxes, grants, and similar nonexchange revenues (general government). Other public-sector activities rely to a significant degree on fees and charges and operate more like a business (utilities). In still other cases, the government may serve as a trustee or agent on behalf of one or more outside parties (pension plan). Accordingly, there are three broad categories of funds (see Exhibit 4-1):

- *Governmental funds* are used to account for activities primarily supported by taxes, grants, and similar revenue sources;
- *Proprietary funds* are used to account for activities that receive significant support from fees and charges; and
- *Fiduciary funds* are used to account for resources that a government holds as a trustee or agent on behalf of an outside party and that *cannot* be used to support the government's own programs.[6]

Fund types

Within each of the three broad categories just described, individual funds are further categorized by *fund type*.

5. There are a number of practical steps a typical government can take to reduce the number of individual funds that it presents in its financial reports: 1) consider combining numerous smaller debt service "funds" into a single fund; consider combining numerous smaller capital project "funds" into a single fund; consider combining grants for similar purposes into a single special revenue fund; and consider using internal service funds only when necessary to support the assessment of charges on an accrual basis. All the same, separate funds must be reported for individual external investment pools and individual postemployment benefit plans. See the Government Finance Officers Association's best practice on "Improving the Effectiveness of Fund Accounting" (2004).
6. Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraph 69.